THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 389 **NOVEMBER 2005**

The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened, is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent.

— George Eliot, *Silas Marner*, 1861

INFLATIONARY RECESSION

With consumer prices up 4.7% year over year and producer prices up 6.7%, the United States has the worst inflation by far among the industrialized countries, with an average of 2.6%. There is a lot of gloating about the low "core" rate in the United States, but ample experience warns that inflationary shocks take their time to penetrate the price system. Meanwhile, the high actual inflation rates are slashing real GDP growth.

The U.S. economy's mainstay of growth, consumer spending, is down sharply since June, to wit, well before the hurricanes hit. The U.S. asset and credit bubbles have gone to such exorbitant excess that an abrupt reversal appears possible, if not probable. The reality of the situation is that the U.S. economy and its financial system have become addicted to continuously greater credit excess. As we shall explain, there is far more economic and financial weakness in the economy than most people realize.

Last year, the world economy staged its strongest growth in history. However, this record in the aggregate was associated with two records of a negative nature. The first one was record differences in the speed of economic growth between countries, and the second one was record differences in the pattern or structure of economic growth. A closer look reveals four distinctly diverging groups of countries.

The top performers with high growth rates and low inflation rates are the industrializing countries of Eastern Asia. With high savings rates, they turned booming exports into booming investment and production, the clear frontrunner of the group being China.

The second-best growth performer in the global economy has been the group of Anglo-Saxon countries, but with the opposite growth models. The common outstanding features are very low, and even negative, domestic savings and, with the exception of Canada, extremely large deficits in foreign trade. Crucial to their economic growth have been house price bubbles providing the collateral for outsized consumer borrowing-and-spending binges, essentially involving steep rises in consumer indebtedness.

The third group comprises all other industrialized countries, among them the eurozone as the single largest unit. Economic growth has generally been on the low side, in particular in Germany, France and Italy. Popular opinion attributes the disappointing growth to rigidities impairing production. For the careful observer, the decisive, fundamental difference to the Anglo-Saxon countries lies in rigid double-digit savings rates of private households, reflecting unusually low consumer spending. Europe has a higher rate of capital formation than the Anglo-Saxon countries, but it is too low in relation to its high savings rates.

A fourth disparate group in the world economy is made up of the oil-producing countries running high and soaring trade surpluses from their booming oil exports.

With high and soaring trade deficits, the Anglo-Saxon countries provided the world with a strong demand impetus. The common factor was housing bubbles, which stimulated consumer borrowing-and-spending

bubbles in all of them. The main beneficiaries in the world were the low-wage Asian countries, with China as the obvious frontrunner.

Among the Anglo-Saxon countries, the U.S. economy clearly has played and continues to play a central role for the world economy, for two reasons. One is the extraordinary size of its trade deficit, and the other arises from the fact that the Asian countries have pegged their currencies to the dollar. Anxious to prevent a rise of their currencies, they have been buying dollars in ever-larger amounts. As this grossly augmented the liquid reserves of their banking systems, they sparked their own investment bubbles.

Yet Asian economic growth is crucially hooked on sustained strong demand growth in the United States. This, in turn, is just as clearly hooked on the full sustenance of its own housing and consumption bubble. Will they oblige or not? This is the most important question for the world economy to investigate.

Why does the U.S. economy have the highest inflation rates? As a matter of fact, it has had the greatest credit excesses for almost 10 years. In other words, the greatest credit inflation.

IDENTIFYING "INFLATION"...

Speaking of inflation, it seems imperative to first emphasize a great difference in its perception between American and European economists. In the United States, inflation is traditionally identified with a sustained rise in prices of good and services. With this in mind, attention is exclusively fixated on consumer and producer price indexes as the key measures of underlying inflation.

With the inflation rates of the past few years rather on the low side by historical comparison, the simultaneous unprecedented credit deluge has been literally ignored. All the while, credit hyperinflated.

European economists of all schools of thought have traditionally strictly distinguished between cause and effect. Inflation of prices is a symptom; inflation of credit is always the disease. The causes affecting the level of prices are too many, and also too complicated, to be attributed exclusively to changes in the money supply.

Ironically, by the way, the worst economic and financial crises in history have always followed extended periods of price stability. Persistently low inflation rates tend to remove any monetary restraint and to encourage risk-taking. The most striking cases of this kind are the Great Depression of the 1930s in the United States and the protracted stagnation of Japan's economy since the late 1980s. Both followed prolonged periods of "price stability."

This difference in concept about inflation, of which very few people seem aware today, is of paramount importance in reality. It goes, actually, to the root of our radical disagreement with the optimistic views about the U.S. economy.

There is actually still a second virtually compelling reason that makes price indexes a bad guide for monetary policy, and that arises from the fact that inflationary borrowing and spending excesses may find very different outlets. What has happened in the last few years in the United States is a particularly extreme case of credit inflation. Yet in contrast to the regular past experience, it showed minimally in the conventional price indexes. Instead, it fueled surging asset prices through carry trade and the exploding trade deficit.

Expecting inflation exclusively in the consumer and producer price indexes, Fed Chairman Alan Greenspan and the bullish consensus interpreted their moderate increase as absence of inflation and conclusive proof of a productivity miracle justifying very loose monetary policy. It never dawned upon them that the existing rampant credit excesses were reflected in the inflating asset prices and the soaring trade deficits.

...AND "CREDIT EXCESS"?

Repeated use of the word "excess" raises the question: excessive relative to what? As to excess demand, the answer is very easy. It implies domestic expenditures in excess of potential domestic output. To have such excess demand showing in rising prices or rising imports, it essentially needs excessive credit.

How to define and measure credit excess? Credit has been zooming upward in the Unites States and several

other countries as never before. Yet policymakers and economists, fixated on the consumer price index, refused to see any trace of inflation. For many years, we have waited for Mr. Greenspan to ever mention the word "credit" in his speeches and congressional testimonies. Though hard to believe, in all his 18 years at the helm of the Federal Reserve, this word has never come over his lips.

During the second quarter of 2005, after 11 rate hikes, total credit in the United States has surged by $2,937.8 billion at annual rate. This compares with a simultaneous annualized increase in nominal GDP by $716.8 billion as the broadest proxy for spending growth. According to these two figures, debt grew four times as fast as GDP.

For perspective: During the three postwar decades until the early 1980s, this debt-to-GDP ratio was 1.4:1. Over decades, this relationship had barely budged. Ever since, it has grown progressively. Debt is growing ever faster in relation to economic activity.

It is the Fed's explicitly declared aim to strive with its rate hikes for the normal or "natural" rate of interest, as defined by Knut Wicksell. Basically, it means an interest rate that exerts neither stimulus nor restraint. But the Swede had another pretty precise definition of that rate: *"The rate of interest, at which the demand for loan capital and the supply of savings exactly agree."* Put a bit differently: where credit expansion and available savings exactly agree.

The basic idea is that credit enables higher spending. To prevent this from inflating prices, the borrowing must be backed by lower consumption through saving from current income.

We have gone into these apparently theoretical details to make one thing of greatest importance perfectly clear. Credit expansion in the United States has grossly run out of reasonable proportions to economic activity. Putting it bluntly: It is completely out of control. What has happened in the United States in the past few years is an inflationary double whammy of simultaneous credit explosion and savings implosion.

Credit and savings have never been targeted by central banks, but the central bankers knew perfectly that their balance was fundamental for financial and price stability. Consider this quote from William McChesney Martin Jr., America's great Fed Chairman during the 1950–60s: *"A spiral of mounting prices and wages seeks more and more financing. It creates demand for funds in excess of savings… If the gap between investment demands and available savings should be filled by creating additional bank money, the spiral of inflation… would be given further impetus."*

INFLATION HAS MANY FACES

The narrow concept of inflation as a rise in consumer and producer prices made perfect sense until the late 1970s, as long as credit excesses used to go overwhelmingly into the purchases of goods and services. But ever since, it no longer makes sense, because credit excesses are dispersed over much wider areas, in particular asset markets and imports.

Judging simply by the atrocious credit and savings numbers, the U.S. economy has the most rampant credit inflation around the world. It shows lately in the huge trade deficit (lately at an annual rate close to $800 billion); it shows in grossly overvalued asset markets running into many trillions of dollars (mainly bonds, stocks and housing). But lately, it is also increasingly showing in the consumer and producer price indexes.

It is a regular comforting mantra in the Fed's FOMC press releases that *"Core inflation has been relatively low in recent months and longer-term inflation expectations remain well contained, but pressures on inflation have stayed elevated."* Emphasis on "core" inflation serves to distract attention from the ugly realities in price inflation.

After all, U.S. inflation rates of consumer and producer prices are now at the top in the world, even despite the Fed's gross understatement. As of September 2005, the PPI was up 6.7% year over year. A year earlier, in August 2004, the 12-month rise was 3.3%. As to the CPI, it showed a rise of 4.7% year over year in September, as against 2.5% a year earlier. Import prices are up 9.9%.

Annualizing the price increases over the last three months, the numbers become outright frightening. For

the PPI, in September, it was 14.8%, for the CPI, 9.4% and for import prices, 20.5%.

Presenting these numbers, we have to repeat our familiar mantra that heavy hedonic pricing and quite a variety of other statistical ploys have substantially reduced the reported U.S. inflation rates. Conservative estimates put their downward effect on the consumer price index at 1–1.5 percentage points per year. Critical observers put them closer to 3 percentage points.

Yet even the officially reported, understated CPI rate of 4.7% has become uncomfortably high, considering that second-round effects of the surge in oil prices are possible, and even probable.

Until quite recently, the Fed prided itself on having learned from Japan's experience that a bursting asset bubble should be treated with fast and massive monetary easing to moderate its aftermath. This assumes, first of all, that belated rate hikes are the main reason for the protracted dismal performance of Japan's economy. It is hard to see how a mere delay in rate cuts can have such devastating long-term effects. In contrast, Japanese experts regard two quite different reasons as most important. They cite structural problems caused by the prior credit excesses and never-ending deflation of house prices.

Mr. Greenspan claims great success that with his policies he managed the U.S. economy's mildest recession in the postwar period. Actually, he replaced the bursting equity bubble with a whole variety of other bubbles, of which the housing and the bond bubbles played the leading roles in fueling America's greatest consumer borrowing-and-spending binge.

The trouble is that with these new bubbles, the U.S. economy and its financial system have accumulated ever-greater imbalances and excesses. And while the ensuing housing bubble saved the economy from deeper recession, it should be realized that a housing bubble is a far more dangerous specimen than an equity bubble. There can be no question that the economy today is in far worse shape today than in 2000–01.

It strikes us that the Fed's increasingly hawkish talk lacks the slightest hawkish action. Rather, it keeps adding reserves to the banking system in order to prevent the federal funds rate from rising above the targeted 3.75%.

In other words, the Fed is accommodating increasing demand for reserves, due to continuous strong credit demand. In general, reserve policy outweighs interest rate policy in its effects on the economy and the markets. It explains why the credit rampage has so far not shown the slightest moderation. In terms of bank reserves, monetary accommodation remains in full force.

We keep wondering what the Fed has in mind with its new policy. First of all, let us make it clear that even a federal funds rate of 4.5% is anything but high compared with present inflation rates. But apparently, it is widely perceived as very high, possibly too high, and that tells us something about the U.S. economy's truly perceived strength.

THE GREATEST BUBBLE IN HISTORY

Up till now, major banks and Wall Street firms have plainly perpetuated the existing asset and spending bubbles by undiminished prodigious lending for carry trade and consumption.

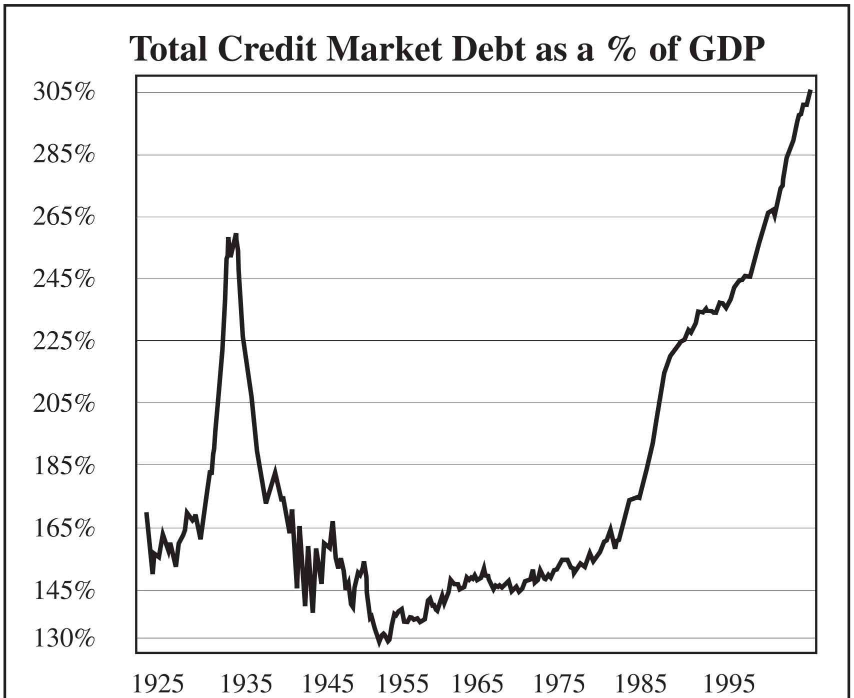
It has long been Mr. Greenspan's mantra that asset bubbles are impossible to recognize before they burst. Saying this, he revealed a shocking ignorance in matters of asset valuation. In reality, nothing is easier to identify than a credit-driven bubble. Just look for soaring credit.

The chart on the next page requires no comment. It shows a credit expansion that has exploded out of control. In actual fact, the Fed wantonly abolished any control of credit in the mistaken view that the economy's moderate inflation rates allowed absolutely free rein to credit expansion.

With their eyes glued to the consumer and producer price indexes as the decisive guides for monetary policy, U.S. policymakers and economists failed to see that ever-greater credit excess poured into asset markets and imports. Nor did they recognize that the accruing equity and housing inflation was increasingly distorting the economy's structure of growth toward consumer spending, and that this was crowding out investment spending and the foreign

trade balance. What developed was a bubble economy par excellence. Instead, the consensus observed and hailed wondrous wealth creation.

The crucial distinguishing factor of an asset price bubble is always the specific source of underlying purchases. Do they come from available savings or from credit creation? In a country like the United States, where savings have vanished in total, nothing could be easier to decide. It should be clear that America's asset price level is exclusively the product of credit-financed carry trade. In short, U.S. asset markets are one gigantic bubble.



Source: Ned Davis Research

Since 2001 in particular, there could never be any trace of doubt about the true origin of the credit explosion and the resulting housing bubble: artificially low interest rates, unrestrained availability of credit and false euphoria about wealth creation. All this definitely qualified it as a rather extreme case of an inflationary asset bubble. A just-published study by Alan Greenspan himself (along with Fed staffer James Kennedy) states that homeowners borrowed $600 billion in 2004 against their home equity, made possible by rising house prices.

For the sake of completeness, we want to add that we also regard the aggressive sales promotions of General Motors and Ford as unsustainable spending bubbles to be followed by huge hits to later sales. Essentially, this artificial short-term boost is at the expense of future sales.

THE FED CONUNDRUM

Early this year, Mr. Greenspan wondered about the "conundrum" of long-term rates declining even while the Fed was hiking short-term rates. Prominent members of the bullish bond crowd are said to be sniffing the impending end of the housing bubble, forcing the Fed to reverse course quite soon and start the game of easing all over again. To quote one of them: *"Let me state categorically that the above sequence is barely questionable, almost inevitable, 99% unavoidable and in modern parlance — 'slam-dunk.'"*

It seems to us that the high inflation rates leave the Fed no choice but to continue its rate hikes. How it will react when the economy unexpectedly slows is another question. Perhaps it hopes that its hawkish talk may help nip stronger inflation expectations in the bud.

We have to say that we believe more in hard facts than in what some people expect or are made to expect. The hard fact about the American consumer is a protracted general decline in family incomes in real terms, as documented by the recent report of the Census Bureau. As inflation has been accelerating, this decline of real incomes is definitely worsening. With consumer price inflation now up 4.7% over the year, as against only 2.6% for average wage earnings, it needs increased borrowing to maintain spending.

While also wondering about the reasons for the interest conundrum, we wonder even more about the Fed's true assessment of the economy's strength. In the press releases about its rate hikes, the FOMC regularly expresses the reason for its composure about the U.S. economy's further performance, which perplexes us: *"The stance of monetary policy remains accommodative, and coupled with robust underlying growth in productivity is providing support ongoing support to economic activity."*

The astonishing part of this sentence is the reference to "*robust underlying… productivity*" as being supportive of economic activity. Productivity growth, as such, does nothing of the kind. Just by itself, it plays no active role in economic activity, creating neither demand nor supply. It is a statistical number derived from dividing inflation-adjusted output through hours worked. And that is it.

THE PRODUCTIVITY CONUNDRUM

On the other hand, we have realized that American economists in general (and Mr. Greenspan in particular) attach singular importance to productivity growth as the all-important source of economic growth and national prosperity. With this perception, however, they virtually stand apart from European economists. Failure to distinguish strictly between causes and effects is again the problem.

What makes productivity growth crucially important for economic growth and wealth creation is not its numerical result, but the whole process of how it comes about. Typically, European economists have taken virtually zero interest in productivity growth, per se. Joseph A. Schumpeter's standard work *Business Cycles* does not mention it with a single word.

Yet European economists were, of course, fully aware of the vital importance of productivity growth. But their thinking about it started with the recognition that it has its crucial source in capital accumulation, employing more machines per worker. Where there is high capital investment, high rates of productivity growth can be taken for granted. Given this basic recognition, they concentrated their investigation on the one question of the conditions that make for high capital investment, and thereby for high productivity growth.

In the end, it is, in fact, all about the cumulative effects of capital investment on income and wealth creation, not about productivity, per se. Investment spending creates employment, income, demand and tangible wealth, while the capital goods are produced. And with their installment, all these capital goods do create higher productivity, employment and incomes from the supply side.

Thinking this through, one realizes that capital investment, rather than productivity growth, is the critical mass in the economic growth process bringing about all the things that generate rising living standards and growing wealth. But capital investment requires saving from current income in the first place, but that's nonexistent in the United States.

It is the particularity of American policymakers and most economists to focus on productivity growth simply and narrowly as a number to be accepted without any question. Since 2000, the government's Bureau of Labor Statistics has reported ever-new records in productivity growth, averaging at annual rate slightly more than 4%.

It is a world record. Most people readily take the numbers as compelling proof of the economy's outstanding performance without asking any critical questions, although both the causes and effects of this productivity miracle lie completely in the dark.

Savings have collapsed; capital investment is by far the weakest component in the economy.

Considering the pronounced structural changes in the economy, the capital-labor ratio has unquestionably fallen. Consumption has soared as a share of GDP, while income growth is lagging as never before. From these conditions, one would logically expect record-low productivity growth. For us, it is the definite economic reality in the United States.

THE FLEXIBILITY MIRAGE

It is time to address another economic miracle that Mr. Greenspan repeatedly implores. That is the U.S. economy's wondrous qualities of flexibility and resilience, supposedly enabling it to absorb and overcome any economic or financial shocks.

Here is a striking example of such remarks in typical Greenspan speak from a speech on globalization given in January 2004:

"Can market forces incrementally defuse a worrisome buildup in a nation's current account deficit before a crisis more abruptly does so? The answer seems to lie with the degree of flexibility in both domestic and international markets. By flexibility, I mean the ability of an economy to absorb shocks, stabilize and recover. In domestic economies that approach full flexibility, imbalances are likely to be adjusted well before they become potentially destabilizing."

It is a preposterous statement, stating in essence that for economies approaching full flexibility — like the U.S. economy — there is no need to worry about imbalances because flexible markets will take care of them before they can do serious harm. In other words, there is no need for the Fed to act against a soaring trade deficit, collapsing savings or any other imbalance.

Indeed, the U.S. economy and its financial system have absorbed several shocks in the past few years — the Asian crisis, the Russian crisis, the Long-Term Capital Management crisis — apparently without serious harm. In all these cases, however, the decisive flexibility to parry the crisis obviously came from the Fed with prompt interest rate cuts and ample liquidity injections. But its ominous final result is a protracted credit deluge doing growing structural damage to the U.S. economy.

Speaking of an economy's flexibility implicitly refers to its ability to correct unsustainable imbalances. The most striking examples of this kind in the U.S. case are the monstrous trade deficit, the budget deficit and the savings collapse. These have developed over many years. Yet we see zero flexibility to correct them. U.S. policy banks on the willingness of foreign investors and lenders to finance it without any limit in time and amount.

As a matter of fact, action for the correction of imbalances always has to come from government policies. If the Fed creates the conditions for credit excess, the U.S. financial system will infallibly oblige. Owing to numerous innovations, it is, indeed, extremely flexible in maximizing credit excess.

But this is definitely undesirable flexibility. Desirable flexibility is the willingness and ability to restrain imbalances and excesses. This desirable flexibility is nonexistent in the United States.

WEALTH ILLUSION AND DELUSION

With all this in mind, we come to the U.S. economy's new growth model, invented and practiced by the Federal Reserve since 2001, and being widely hailed as a valid new model of asset-driven growth, in contrast to the traditional model of job- and income-driven growth.

Our opposition begins with the view that this popular label is deceptively euphemistic. The key growth propellant is by no means housing assets as such, but the associated rampant debt creation. Plainly, this is debt-driven growth, in contrast to income-driven growth. But this description would, of course, entail a bad taste, which nobody wants.

Further, we rigorously object to the conventional practice in the United States to describe and treat increasing asset prices principally as "wealth creation." In this explicit assessment, the United States is unique in the world. In various other countries, too, housing bubbles have been turned into borrowing-and-spending bubbles. Nowhere, however, is there such ballyhoo about implicit wealth creation as in the United States.

The Federal Reserve even explicitly documents this so-called wealth creation in its quarterly Flow-of-Funds Accounts. There, it says on page 102 of the last report that the net worth of American households has jumped from \$41.7 trillion to \$49.8 trillion during the 4½ years from 2000 to Q2 2005, mainly due to the fact that the soaring market value of owned real estate vastly outpaced the simultaneous increase in liabilities.

House prices have, actually, risen sharply around the globe. Japan, Germany and Switzerland are the notable three exceptions. However, even between the numerous countries with rising house prices, there has been an enormous difference in how policymakers and the public assess and treat them.

Equity withdrawal — that is, extraction of housing equity through borrowing against rising house prices as collateral — is the crucial dividing factor. It is a widespread practice in all Anglo-Saxon countries. In the rest of Europe, it is the exception.

While several European countries also have sharply rising house prices, in particular France, this finds very little or no publicity at all. Neither policymakers nor the media nor the public talk of wealth creation, and neither is there a correlated borrowing binge. Assessing rising house prices explicitly and exuberantly as wealth creation is an American specialty.

Striking proof that Europeans in general do not conceive of rising asset prices as wealth creation and a valid substitute for saving are tenaciously high rates of saving from current income in the face of sharply rising house prices.

What is wrong with this idea of wealth creation through rising asset prices? In essence, it reflects a general rise in the price level of housing. Emphasis is on "general." Housing has all around become considerably more expensive. Assuming sustained comfort and quality of locality, there is clearly no gainer. There are only losers; to wit, those who are living in rented homes.

But have not many people made big financial gains by borrowing against the rising values of their houses and thus raised their living standards? Yes, but they have depleted their capital available for future house purchases. Over and above, the higher debts involve, of course, higher debt service from future income.

Putting it shortly and bluntly: There is zero wealth creation when all house prices rise. Its true name is inflation, adding nothing to "real" value.

Frankly speaking, we see a general gross illusion among people behind this ballyhoo in the United States about the inherent prodigious wealth creation through rising house prices. But as for the policymakers and leading economists who are publicly trumpeting this stupid message, we presume deliberate, systematic delusion of the public in a desperate attempt to drive up consumer spending in the face of falling real incomes.

WHEN A HOUSING BUBBLE BURSTS

It is an entirely different question, of course, what will happen to equity and house prices and the associated phony wealth creation in the United States and other bubble economies when the rise in house prices stops for whatever reason.

Housing bulls, apparently, take comfort from past experience that house prices have never fallen in nominal terms, only in real terms. Many, moreover, firmly believe that the Greenspan Fed will ease drastically on the slightest hint of trouble in the economy or the financial system, as it has done again and again in the past.

Assessing the economic and financial situation in the United States, it has to be realized, first of all, that the accumulated excesses and distortions in borrowing and spending both in the economy and the financial system have no precedent in history in their extraordinary scale and pattern. An old rule of experience says that the severity of a crisis is in essence proportionate to the size of the excesses in the prior boom.

In the bullish consensus view, Mr. Greenspan has done a great job in coping successfully with various shocks. Yes, but through the extreme monetary looseness that he has pursued over many years, he himself had set the stage for those shocks.

For many people, his prompt and drastic easing in 2001–02, through which he virtually replaced the bursting equity bubble with the housing bubble, was his greatest success. This laudation overlooks that property bubbles are incomparably more dangerous than equity bubbles.

In its *World Economic Outlook* of April 2003, the International Monetary Fund published a study titled "When Bubbles Burst," comparing the repercussions of equity price busts and of housing prices busts. Its general conclusion said:

"An important theme running through the foregoing analysis is that housing price busts were associated with more severe macroeconomic developments than equity price busts. Coupled with the fact that housing price booms were more likely (than equity price booms) to be followed by busts, the implication is that housing price booms present significant risks…"

Subsequently, the IMF denominates several reasons for this assessment:

(1) Housing price busts have larger wealth effects on consumption than equity price busts. Housing price busts were associated with stronger and faster adverse effects on the banking system than equity busts.

(2) Housing price busts were more likely to have been preceded by a boom so that there were larger imbalances to be unwound.

(3) Price spillovers across asset classes matter, as evidenced by the fact that housing price busts were more likely associated with generalized bear markets, or even busts, than equity price busts.

In our view, there are three decisive and most alarming differences between equity and housing bubbles: *first*, in the much larger participation of the public; *second*, in the extensive participation of the financial system; and *third*, in the associated runaway debt creation. On all three accounts, the present housing bubble in the United States has gone to unprecedented excess.

In short, an equity bubble generally implicates only a minority of people of some wealth. The usual way for investors to turn capital gains into ready cash is to sell part of the equity. There is very limited involvement of the financial system in financing cash withdrawals.

The housing bubble, in contrast, potentially involves the bulk of the population well down the ladder of prosperity. The manifest most critical distinction between equity and housing bubble is the associated exorbitant run-up in debts, heavily involving the financial system.

IN SEARCH OF THE TRUTH

The safest thing to say about an asset and credit bubble is that it cannot and will not last. It has been an unusual, new characteristic of all Anglo-Saxon bubble economies that monetary looseness worked mainly through house price inflation on consumer spending while leaving business fixed investment rather sluggish. Everywhere, the share of consumption expenditures in gross domestic product rose sharply.

Essentially, this growing share of consumption had to be at the expense of other GDP components. As government spending also rose, the essential losers were business fixed investment and the trade balance, the latter showing spectacularly in unprecedented current account deficits. Putting it into formerly familiar parlance: Excessive consumer spending has been crowding out investment and foreign trade.

All these countries have been boasting of significantly stronger economic growth than in the “sick” eurozone. Policymakers and economists conveniently overlook that the stronger economic growth entailed unprecedented and unsustainable increases in consumer indebtedness and tremendous, unsustainable distortions in the pattern of demand and output.

Meanwhile, in some Anglo-Saxon countries, an abrupt, sharp decline of consumer spending and economic growth has taken everybody by surprise. As to the U.S. economy, we wonder what is truly happening lately, because what we see is radically different from what the consensus and the Federal Reserve declare to be seeing.

The release of the minutes from the Sept. 20 Fed meeting expressed the FOMC’s commitment to keeping inflation in check, but also the central bank’s view that the U.S. economy is strong, resilient and should rebound before long. This is in line with the consensus view among economists, predicting a 3.5% trend-like pace of growth of the economy as far as the eye can see, apparently assuming that further rate hikes will not weaken economic growth.

We have to say that this scenario drastically differs from what we see on our part. In our view, American economic analysis and thinking suffer from a gross overproduction of surveys and statistics, with the result that too many trees are obstructing the view of the forest.

Our focus is on four aggregates in the U.S. economy that are plainly crucial in determining its further growth performance. These are inflation, consumer spending, consumer incomes and business investment. Frankly speaking, we see nothing positive in all of them.

As to inflation, we read with amazement, for example, that inflation readings have been benign. The reference is, of course, to the “core” rate. Yes, but this is a pure fiction for people spending their current income

at the actual, overall inflation rate, and this happens to be far in excess of any prior expectations.

As of the end of September, the overall consumer price index stood 4.7% higher than a year earlier, and the producer price index even at 6.5%. By stressing the so-called “core” rate, the Labor Department and Wall Street attempt to spin the horrific facts into something palatable.

To understand the actual, dismal economic reality in the United States, this 4.7% rate of consumer price inflation has to be compared with the simultaneous increase in earnings from employment, up 2.6% year over year. Taking into account the variety of statistical ruses to lower the reported inflation, the true rate, rather, hovers closer to 6%. This is definitely far worse than just stagflation.

Yet even the lower understated inflation rates take a heavy toll on incomes and spending.

Stating this, we hasten to add that, in contrast to Fed and Wall Street consensus, we see a sharply slowing economy and a very fragile financial system.

First of all, we note an abrupt downturn in consumer spending. Rising during the second quarter of 2005 by $64 billion in chained dollars, it contributed 71% to the reported real GDP growth. Now, what happened to it in the third quarter? According to the “Personal Income and Outlays” report of the Bureau of Economic Analysis, consumer spending decreased in July–August by a net amount of $6.1 billion. For September, we know that total retail sales, meanwhile, rose just 0.2%. With consumer price inflation simultaneously up 1.2%, this represents a steep drop in real terms.

These numbers from an official source suggest that inflation-adjusted consumer spending has slumped into negative territory in the third quarter. Considering its eminent role in driving U.S. economic growth, this certainly seems a shattering negative effect. However, we note complete disregard among economists.

Comments on the disastrous September retail number generally focused, instead, on one detail giving it apparently a palatable touch. It said that, ex the slump in auto sales, retail sales would have surged by 1.1%. Emphasis on this point implicitly suggested a temporary aberration. Yes, but it followed very weak auto sales already in August, and available numbers for October show a further, even steeper fall.

It was never in question that the aggressive sales promotions of autos in the past few years would have a painful payback sometime in the future. Perhaps that payback has started considering that October is the third straight month of weak auto sales.

BUSINESS IS NOT TAKING THE BATON

How is it possible that these blatantly disastrous facts about consumer spending are in general flatly ignored? The answer may be in the quote on the first page from George Eliot: *“The sense of security more frequently springs from habit than from conviction.”*

From the many reports we read, we concluded long ago that there is in any case very little individual, independent research among economists.

Now read this from the just-published *World Economic Outlook* of the International Monetary Fund: *“In the United States, GDP growth remained strong in the first half of 2005, underpinned as in 2004, by strong income growth and steady improvements in labor market conditions, and rising house prices…*

“Against this background, GDP growth is projected to be somewhat weaker than previously expected in the latter part of 2005, with private consumption affected by higher gasoline prices and population displacement (from the hurricanes). In 2006, growth is expected to return to trend, driven primarily by a pickup in fixed investment, reflecting firms’ healthy balance sheets, strong profitability and capital stocks that are below trend in some sectors.”

From what we read, this quote is perfectly in line with the bullish consensus in the United States, stating basically that any current economic weakness comes from higher oil prices and the hurricanes. Conclusively, there is nothing wrong in the U.S. economy. What can you expect from Wall Street economists when this comes

from the International Monetary Fund?

Our utter amazement begins with the first sentence, speaking of *"strong income growth and steady improvements in labor market conditions."* The truth is that over the last 12 months, an increase in real consumer spending by 3.5% can be compared with an increase in real disposable personal income by just 1.4%.

The two numbers give an idea how much the present living standard in the United States depends on borrowing, rather than income and productivity growth. Yet even these poor income numbers are considerably flattered in several ways. It begins with the understated inflation rate. And earnings from wages and salaries have their main source in the employment growth from the dubious Net Birth/Death model.

The good-looking, low unemployment rate, in turn, owes its existence entirely to the Labor Department's dubious practice to discard people who have not actively looked for a job. A recent paper by the Federal Reserve Bank of Boston puts the number of these so-called discouraged workers at 5.1 million. Taking these into account, the true number of jobless would be over 8% of the labor force, rather than the reported 5%.

AMERICA'S INCOME DESTROYER

It is another most astonishing thing about the economic discussion in the United States that the protracted tremendous shortfall in income growth of private households finds almost no attention. Policymakers and economists appear to be fully satisfied that credit creation through the housing bubble is enabling the consumer to supplement his poor earnings with a prodigious resort to mortgage refinancing.

Normally, as a matter of fact, all spending creates corresponding income. It may be pictured as a circular flow. Put differently, total spending should equal total income. It rarely does, for statistical reasons. But the protracted tremendous difference between the two in the United States cannot be dismissed as a statistical quirk. As described earlier, consumer spending is up 3.5% over the last 12 months and consumer real disposable income up a mere 1.4%. This enormous difference must have a fundamental cause.

The tacit and favored explanation is the stellar productivity growth. It gives it a very positive touch. While this may seem quite logical superficially, it is an absurd assumption that productivity growth reduces overall income growth. Above all, however, the main cause of this extraordinary divergence is easily identified.

As we have already repeatedly explained, it is the U.S. economy's monstrous current account deficit. The unbelievable thing is that American policymakers and most economists completely fail to realize this. All they see is that cheap imports help to keep inflation low.

Net imports, as a matter of fact, are principally subtracted from the calculated amount of domestic spending in the national income and product accounts. Apparently, many people are not aware of this. In contrast, however, the registered increase in consumer spending contains both imported and domestically produced goods and services.

The crucial point here is that imports reduce the spending and income stream flowing to the domestic producers by the same amount. The alternative recipients are the foreign producers. In essence, the huge trade deficit acts as an inbuilt big income destroyer in the U.S. economy.

NEGATIVE RESTRUCTURING

The stupendous trade deficit is the product of stupendous credit excess accommodating stupendous consumption excess. This is really America's fundamental disease. But this overconsumption, as reflected in a rising share of consumption in GDP, has a further grave damaging effect in that the credit-driven consumption excess is crowding out capital investment and foreign trade.

Putting it into the parlance of Friedrich Hayek: *"The U.S. economy is experiencing a shrinking production structure in the sense that employment is shifting from sectors with high capital input (manufacturing) to sectors with low capital input."* In actual fact, this kind of structural downgrading is to be expected in the case of an economy without savings. You might say the economic structure is adjusting to poor or zero capital

formation. Essentially, this is negative restructuring.

In short, it is an economy in which capital investment goes down the drain. However, we read good news that business fixed investment will pick up, as the IMF puts it, *"reflecting firms' healthy balance sheets, strong profitability and capital stocks that are below trend in some sectors."*

True, all this has been happening. But on closer look, we are more than doubtful about this optimistic interpretation. Nonfinancial businesses have, indeed, enormously strengthened their balance sheets. But how did they achieve this? In short, by retarding fixed investment. Though it has recovered from its low in 2003, lately it is no higher in nominal terms than in 2004.

Now, the bullish community interprets the higher liquidity as a prelude to stronger investment. On closer look, we wonder about a distinct, general aversion to fixed capital investment on the part of Corporate America. It has widely gone unrecognized that this sudden surge in profits and liquidity has an ominous source: plunging depreciations.

Since the third quarter of 2004, "capital consumption allowances" for nonfinancial corporations are down from \$830.2 billion to \$647.6 billion. Essentially, this translated into sharply higher profits, slightly higher liquidity and sharply higher taxes. Is this a positive or a negative development? It shocks us.

Consider these numbers: In 2004, business capital spending exceeded cash flow by \$310.9 billion. Simultaneously, corporations bought outstanding shares for \$118 billion. In the second quarter of 2005, their fixed investment slightly lagged cash flow, but their stock buybacks amounted to \$294.4 billion at annual rate.

Many years of unprecedented credit excesses in the United States have resulted in rampant inflation of asset prices and consumption on one side and savage deflation in capital formation on the other. The inescapable income is the savage deflation of the former.

CONCLUSIONS:

U.S. economic growth depends precariously on the full-blown continuance of the housing and refinancing bubbles as the shortfall of consumer incomes continues unabated. In addition, accelerating inflation rates are taking their toll. Consensus economists remain steeped in denial.

For sustained economic growth, it is imperative that corporations take the baton from the struggling consumer with a strong pickup in fixed investment. There is no reasonable indication this will happen. Instead, they are pouring record amounts into stock buybacks, mergers and acquisitions.

The bulls will jump at the idea that new rate cuts by the Fed will quickly reverse the situation in the markets and the economy. But there is little room for new monetary and fiscal stimulus, while the economy is in far worse shape than in 2000. After all, the Fed is sure to "push on a string."

But do not think that bonds will be a safe haven under these circumstances. Being built completely on highly leveraged carry trade, they are extremely vulnerable to any kind of disturbance.

THE RICHEBÄCHER LETTER

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